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People's Republic of China Bankruptcy Law

Mr. Ravi Bendapudi*

I. Introduction

In 2007 the People's Republic of China (PRC/China) will implement a sweeping new bankruptcy law designed to bring its national bankruptcy system into line with international standards. During the past twenty-five years the PRC has undergone one of the greatest social and economic transformations in human history. In less than two generations China has transformed from a struggling communist country, bent on isolation, into a pillar of the world's economic and political systems. This growth, however, has not been uniform across all sectors of the economy and civil society; the legal system has struggled to keep pace with the demands of a more open and dynamic market economy. The Chinese bankruptcy law in particular is undergoing major changes to deal with an economy that is vastly different from the one that China's first Enterprise Bankruptcy law sought to address in 1986.¹ Additionally, China's accession to full membership in the World Trade Organization (WTO) has triggered many complex responsibilities and obligations, and sound and dependable bankruptcy laws will ensure the successful implementation of those obligations.

The new Chinese bankruptcy law, if properly enforced and executed, could potentially have profound consequences for the economy and social fabric of China.² The new bankruptcy law could lead to higher unemployment as well as

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1. Weijing Wu, *Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy Law*, 35 VICT. U. WELLINGTON L. REV. 239, 240 (2004).
2. See Weitseng Chen, *WTO: Time's Up for Chinese Banks-China's Banking Reform and Non-Performing Loan Disposal*, 7 CHI. J. INT'L L. 239, 239-42 (2006) (author discusses the

banking sector volatility, the overall effects of which could also cause social instability.³ China's participation in the WTO adds further uncertainty to the process of economic and legal reform. The impact of China's new bankruptcy law, therefore, must also be analyzed in the context of its compliance with its WTO commitments.⁴

This paper will discuss the history of bankruptcy law in China, and the newly-adopted 2006 Enterprise Bankruptcy Law ("2006 bankruptcy law"), which will go into effect in 2007. This paper will also look at the possible consequences of the new bankruptcy regimen on the greater Chinese economy after it achieves greater compliance with its WTO protocol.

II. Background

After the founding of the PRC in 1949, the communist government moved quickly to consolidate control over real property, banking, industry, and commerce.⁵ Private property was seized, and factories and businesses were forced to nationalize or close.⁶ All major commercial enterprises and industries came under the ownership and control of the central government as state owned enterprises (SOE).⁷ The SOE became the backbone of the centrally controlled Chinese economy.⁸ Generous subsidies from the state, coupled with lack of competition from the private sector, meant that Chinese SOEs could never go bankrupt. Furthermore, the constitution-based civil law system of the Republic of China was eliminated in favor of the wholesale adoption of the communist Soviet economic/political model. As a result, China's business law framework was virtually non-existent until the late 1970s. Bankruptcy as a concept and the laws to govern the system were also non-existent in communist China.⁹ In fact, bankruptcies, especially situations where enterprises were liquidated and

impact of competition from foreign banks on Chinese state owned banks, and the potential reaction of Chinese depositors when the domestic banking system is liberalized following WTO accession).

3. See Wu, *supra* note 1, at 244 (explaining the "triangular" connection between banking, bankrupt SOEs and unemployment).
4. See Wei J. Lee, *China and the WTO: Moving Toward Liberalization in China's Banking Sector*, 1 DEPAUL BUS. & COM. L.J. 481, 481-93 (2003) (examining China's WTO protocol and what that means for banking and economic reform).
5. See JOHN KING FAIRBANK & MERLE GOLDMAN, *CHINA: A NEW HISTORY* (1998).
6. *Id.*
7. *Id.*
8. Wu, *supra* note 1, at 242.
9. JAMES M. ZIMMERMAN, *CHINA LAW DESKBOOK* 1-3 (2nd ed. 2005).

employees were put out of work, were viewed by Chinese communist officials as one of the more glaring failures of the capitalist economic system.¹⁰

A. The 1986 Chinese Enterprise Bankruptcy Law

In the late 1970s under the leadership of late Premier Deng Xiaoping, China began to abandon the Soviet/Communist economic model and started to introduce market reforms.¹¹ This period, known in Chinese as “opening and reform,” marked the return of private enterprise and competition to the domestic economy. In response, the National People’s Congress introduced the first Chinese Enterprise Bankruptcy Law in 1986.¹² However, the 1986 bankruptcy law did not adequately address the complexities of insolvency in the transitioning Chinese economy, and it was also weakened by major discrepancies in enforcement. Until the new 2006 Bankruptcy Law goes into effect, the 1986 law will remain, on paper, as the primary piece of legislation governing bankruptcy on a national level in China.¹³

The 1986 law is flawed in many respects; first and foremost it only applies to SOEs and makes no mention of private sector bankruptcy.¹⁴ The 1986 Enterprise Bankruptcy Law, therefore, does not apply to foreign-invested joint ventures, limited liability companies, partnerships, or sole proprietorships.¹⁵ In the early 1990s, to remedy the lack of coverage for non SOEs, the Chinese government passed Chapter 19 of the Civil Procedure Law, which created some private sector bankruptcy legislation.¹⁶ The civil legislation, like the 1986 Bankruptcy Law, was flawed in that it lacked procedural guidelines, thereby making it very difficult for companies to file for bankruptcy in practice.¹⁷ Thus, some observers have commented that the passage of the first Enterprise Bankruptcy Law in 1986, and subsequent supplementary legislation, served more to deliver a political message to

10. Wu, *supra* note 1, at 243.

11. See FAIRBANK & GOLDMAN, *supra* note 5.

12. 中華人民共和國企業破產法(全國人民代表大會常務委員會第十八次會議) Zhonghua Renmin Gongheguo Qiye Pochan Fa (Quanguo Remin Daibiao Dahui Changwu Weiyuanhui Di Shiba Ci Huiyi) (Promulgated at the 18th Session of the Standing Comm. Nat’l. People’s Congress., Dec. 2, 1986) [hereinafter 1986 Bankruptcy Law].

13. See Wu, *supra* note 1, at 243-52.

14. James H.M. Sprayregen et al., *The Middle Kingdom’s Chapter 11?: China’s New Bankruptcy Law Comes into Sight*, 23 AM. BANKR. INST. J. 34, 60 (2005).

15. Helen H. C. Peng, *The Bankruptcy Law of P.R. China*, in 2 28TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY & REORGANIZATION, COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES 53, 59 (2006).

16. *Id.*

17. *Id.*

the outside world, and to jolt SOEs into functioning more efficiently, than to actually direct the effective clearance of bankruptcy cases.¹⁸

B. Inefficient Liquidation System

The bankruptcy framework in China also had many built-in disincentives and barriers to declaring bankruptcy under the 1986 law. For example, the only course of action for a bankrupt company to undertake was liquidation.¹⁹ If a company was deemed to be unable to service its debt payments when due, it could be declared bankrupt and, consequently, subjected to liquidation.²⁰ In theory, under the 1986 laws the only recourse for a debtor or creditor who initiated a bankruptcy—in China a bankruptcy filing may be made by either party—was liquidation; no provisions for corporate reorganization existed.²¹ However, liquidation may not be suitable in all bankruptcy situations, as many companies unable to make debt payments might be able to get back on track after a period of supervised reorganization.

Along with liquidation comes the lengthy and complicated process of terminating workers and distributing company property to the appropriate creditors. This process is handled by a court appointed Liquidation Committee.²² Unfortunately, the liquidation process is often abused and mismanaged due to unprofessional oversight and misappropriation of assets by corrupt officials.²³ Additionally, the committee is usually made up of government bureaucrats and administrators, not accountants or lawyers.

C. Criminal Penalties for Business Failures

A further, significant, disincentive to declaring bankruptcy under the system governed by the 1986 law was the provision allowing courts to hand down

18. Shirley S. Cho, *Continuing Economic Reform in the People's Republic of China: Bankruptcy Legislation Leads the Way*, 19 HASTINGS INT'L. & COMP. L. REV. 739, 745 (1996) (author describes the legislative process in China as producing laws that function more as moral guidelines than law).

19. Wu, *supra* note 1, at 249-50.

20. Xianchu Zhang & Charles D. Booth, *Chinese Bankruptcy Law in an Emerging Market Economy: the Shenzhen Experience*, 15 COLUM. J. ASIAN L. 1, 7-8 (2001).

21. Cho, *supra* note 18, at 748-49.

22. See Charles Booth, *Drafting Bankruptcy Laws in Socialist Market Economies: Recent Developments in China and Vietnam*, 18 COLUM. J. ASIAN L. 93, 94-111 (2004) (comparing the development and reform of bankruptcy laws in China and Vietnam).

23. *Id.*

criminal penalties to company executives for business failures.²⁴ Since the 1986 Bankruptcy Law only addressed SOE bankruptcies, any business failure could therefore be considered a “serious loss of state property,” which could carry criminal penalties under the Chinese system.²⁵ This punitive provision also served to shame directors and officers of SOEs that were at risk of bankruptcy, and that clause is consistent with the legislative intent of the Chinese lawmakers to scare the managers of struggling SOEs into self-imposed restructuring.²⁶

D. Existing Bankruptcy System Was Underutilized

Another major criticism of the Chinese bankruptcy system was the government’s reluctance to use and enforce existing laws.²⁷ In an effort to maintain strict government control over the fate of potentially bankrupt enterprises, the 1986 law required SOEs to obtain government approval before initiating a bankruptcy declaration.²⁸ The approval process allowing for an SOE to apply for bankruptcy was usually left up to local government agencies, the same local bureaucracies that were responsible for administering the SOE in the first place. Many local government officials maintained close relationships to the SOEs in their jurisdictions and came under pressure from local interests, as well as the central government, to deny those bankruptcy applications.²⁹ The evaluation process used by local governments was not transparent and was likely based on any number of factors—from the possible impact of a bankruptcy on local unemployment, and other social factors, to more self-serving interests such as dishonesty and corruption.³⁰ Whether a filing was allowed to move forward or not seemed highly arbitrary and inconsistent because of the wide latitude given to the thousands of local government entities.³¹ Such obstacles to filing for bankruptcy resulted in the underutilization and under-development of the bankruptcy system in China. It also reaffirmed the notion that bankruptcy serves more as a symbolic threat that the government used to scare SOE managers into improving company performance.³²

24. Cho, *supra* note 18, at 748-49.

25. *Id.*

26. *Id.*

27. *Id.*

28. Booth, *supra* note 22, at 108-09.

29. Wu, *supra* note 1, at 244-45.

30. See Booth, *supra* note 22, at 108-09.

31. *Id.*

32. Wu, *supra* note 1, at 243-44.

E. Parallel Bankruptcy Systems Complicated the Process

Another problem compounding the development of an effective bankruptcy law system in China is the existence of parallel bankruptcy legislation at the sub-national level. One such example is the bankruptcy system in place in the Shenzhen Special Economic Zone (SEZ) of Guangdong Province. As one of China's most dynamic and developed localities, Shenzhen was granted the authority to develop its own bankruptcy law to accommodate the growth in trade and commerce, so long as the laws did not conflict with national laws.³³ Pursuant to this policy, Shenzhen instituted its own comprehensive local bankruptcy legislation called the Shenzhen SEZ Enterprise Bankruptcy Regulations.³⁴ The Shenzhen laws have, by and large, done away with the more cumbersome elements of the 1986 Enterprise Bankruptcy Law.³⁵ The Shenzhen system applies to all enterprises (non-SOEs included) registered in, or residing within the SEZ.³⁶ Though the Shenzhen legislation appears more tailored to the complex needs of bankruptcies in a market economy, the existence of parallel laws contributes to the lack of uniformity and provides for potential confusion, especially when dealing with a bankrupt company that also has operations and property outside of the dually-regulated local area.³⁷

III. Bankruptcy Reform

The Chinese government has long recognized the need for a total overhaul of the 1986 Bankruptcy Law in order to establish a functional system of national business laws.³⁸ In addition to the rapid transformation of the Chinese economy since the first bankruptcy law came out in 1986, China's accession as a full member of the WTO, effective 2001,³⁹ and the traumatic experience of its ASEAN (Association of Southeast Asian Nations)—neighbors during the 1997/1998

33. Zhang & Booth, *supra* note 20, at 5-9.

34. *Id.*

35. *See id.* Some of the major changes include: 1. elimination of the government approval requirement, 2. rules for the court to supervise the liquidation committee, and 3. development of a specialized judicial branch with experience dealing with bankruptcy cases. *Id.*

36. *Id.*

37. Peng, *supra* note 15.

38. Sprayregen et al., *supra* note 14, at 34, 60.

39. *See Lee, supra* note 4.

Financial Crisis, have put pressure on the Chinese legislature to develop and implement meaningful bankruptcy reform.⁴⁰

China's compliance with its WTO accession protocol will require it to develop a functioning and responsive national bankruptcy system to complement the major changes that are expected to occur across the economy as WTO-related protocols go into effect.⁴¹ While the Chinese government prepares itself for unprecedented market openness as a full member of the WTO, it is also trying to brace itself for economic turbulence that may occur in the future. The Chinese government was afforded a valuable opportunity to observe the consequences of having weak or nonexistent bankruptcy systems in the late 1990s when economies collapsed across Southeast Asia as bad loans and bankrupt companies crippled the formerly unstoppable "tiger" economies.⁴²

A. The New 2006 Chinese Corporate Bankruptcy Law

The new Chinese bankruptcy law that will go into effect in June 2007⁴³ introduces sweeping changes to the existing system and brings Chinese bankruptcy law, on paper at least, up to international standards.⁴⁴ While drafting the new law, Chinese lawmakers drew upon the bankruptcy legislation of many other countries, such as the United States, Japan, the United Kingdom and France.⁴⁵

B. The New Law Has a Much Broader Scope

Unlike the previous bankruptcy law, the new 2006 law broadens the availability of bankruptcy proceedings to cover all types of business entities, not just SOEs.⁴⁶ Partnerships, limited liability companies, foreign-invested enterprises, and even sole proprietorships are covered under the new law.⁴⁷ However, private individuals

40. Sprayregen et al., *supra* note 14.

41. See Lee, *supra* note 4.

42. See Michelle Schreiber, *Beyond the Economic Turmoil of the Asian financial Crisis: Indonesia's Struggle to Cope with Insolvency*, 12 TRANSNAT'L LAW. 353 (1999).

43. 中華人民共和國企業破產法(2006年8月27日第十屆全國人民代表大會常務委員會第二十三次會議) Zhonghua Renmin Gongheguo Qiye Pochan Fa [Law of the People's Republic of China on Enterprise Bankruptcy] (8/27/2006 Di Shi Jie Quanguo Renmin Daibiaodahui Changwu Weiyuanhui Di Ershisan Ci Huiyi) (Promulgated at the 23rd Session of the Standing Comm. Nat'l. People's Cong., Aug. 27, 2006, Effective 2007), translated in ISINOLAW [hereinafter 2006 PRC BANKRUPTCY LAW].

44. See Peng, *supra* note 15.

45. *Id.*

46. *Id.*

47. *Id.*

are still unable to declare personal bankruptcy under the new law.⁴⁸ The unavailability of personal bankruptcy protection is probably necessary since China's consumer credit infrastructure is still relatively under-developed.⁴⁹

The new law also eliminates the requirement that a bankrupt firm first obtain approval from the relevant government agency prior to declaring bankruptcy.⁵⁰ The new law preserves the right of both the debtor and the creditor to initiate a bankruptcy proceeding.⁵¹

C. New Law Shifts Focus from Liquidation to Corporate Reorganization

A major shift in the 2006 law allows for qualifying Chinese companies to opt for corporate reorganization or rehabilitation rather than the forced liquidation bankruptcy of the past.⁵² Chapter Eight of the new law provides for a six month reorganization period, extendable by three additional months, where the debtor must submit a reorganization plan to both the People's Court and its creditors for review.⁵³ The law further provides for mandatory liquidation if the bankrupt company is found to be pursuing reorganization in bad faith, or if the company's situation continues to deteriorate "with little or no prospect of rescue."⁵⁴ The new legislation also carves out an exception for when the creditor company itself is in danger of insolvency as a result of the debtor's default, in which case the court may bypass reorganization completely and move straight to liquidation.⁵⁵

Chapter Eight of the new law is modeled after the United States' Bankruptcy Code.⁵⁶ Under this law the company undergoing reorganization will be required to disclose all of its debts and assets to its creditors.⁵⁷ The creditors in turn will hold a statutorily required creditor's meeting with the debtor company in order to review the reorganization plan and vote on whether or not it should be implemented.⁵⁸ Unlike the United States' Bankruptcy Code, however, the Chinese creditors are not allowed to submit their own competing reorganization plan.⁵⁹

48. Wu, *supra* note 1, at 246.

49. *Id.*

50. *Id.*

51. 2006 PRC BANKRUPTCY LAW, *supra* note 43, at art. 4.

52. Sprayregen et al., *supra* note 14, at 34, 60.

53. 2006 PRC BANKRUPTCY LAW, *supra* note 43, at ch. VIII, §2, art. 79.

54. *Id.*

55. *Id.*

56. Sprayregen et al., *supra* note 14, at 34, 60.

57. 2006 PRC BANKRUPTCY LAW, *supra* note 43, at ch. VIII, §1, art. 81 (2006).

58. *Id.* ch. VIII, §2, arts. 84-87.

59. See Sprayregen et al., *supra* note 14, at 34, 60.

Instead, the new Chinese Bankruptcy Law allows for the debtor and the dissenting creditors to consult with each other and negotiate an amended reorganization plan.⁶⁰ The final version of the reorganization plan must then be submitted to the People's Court. The People's Court then reviews the reorganization plan before announcing it publicly.⁶¹ A court appointed Receiver, or Administrator,⁶² as well as the creditors of the company, will monitor the implementation and progress of the reorganization plan.⁶³

Corporate reorganization should give the debtor companies the opportunity to rehabilitate themselves and hold onto some of their operations in tact. The opportunity to reorganize and restructure might also lessen, to an extent, the more painful aspects of mass unemployment and repossession that usually accompany corporate liquidations. Additionally, the new laws' emphasis on reorganization as opposed to liquidation might also make the declaration of bankruptcy more palatable to companies that are heavily in debt since they will not necessarily be forced to liquidate all of their property and cease operation.

D. A Qualified Administrator Appointed by the Court to Oversee the Bankruptcy

Another aspect of the new law, which actually builds on existing provisions from the 1986 law and should promote the efficient implementation of a bankruptcy proceeding, is the court appointment of a *qualified* Bankruptcy Administrator to oversee the reorganization or liquidation.⁶⁴ In the past, the court-appointed Administrator, or Receiver, was designated by the local government of the jurisdiction where the bankrupt company was based.⁶⁵ Bankruptcy Administrators that were drawn from the local government bureaucracy were often unqualified to handle the complex legal and financial transactions involved in a typical bankruptcy case.⁶⁶ The 2006 law specifies that lawyers, accountants, and professional bankruptcy liquidators shall be appointed to oversee cases.⁶⁷ More importantly, the law also specifies who shall *not* be appointed to administer bankruptcies.⁶⁸ Article 24 specifically forbids the appointment of people who have

60. 2006 PRC BANKRUPTCY LAW, *supra* note 43, at ch. VIII, §1, art. 87.

61. *Id.* ch. VIII, §1, art. 87-88.

62. *Id.* ch. III, art. 24.

63. *Id.* ch. VIII, §3, art. 90.

64. *Id.* ch. III, art. 24.

65. Sprayregen et al., *supra* note 14, at 34, 60.

66. *Id.*

67. 2006 PRC BANKRUPTCY LAW, *supra* note 43, at art. 24.

68. *Id.*

criminal records, people who have had their professional licenses revoked in the past, and people who have a potential conflict of interest in the case.⁶⁹ The law reserves to the discretion of the court the ability to disqualify potential administrators it finds “unsuitable for other reasons.”⁷⁰

The Receiver/Administrator plays a very central role in the execution of a bankruptcy case. He or she is responsible for overseeing the day-to-day expenses of the debtor company undergoing reorganization, and for deciding on the internal management affairs of the debtor.⁷¹ The Administrator also oversees the distribution and disposal of the debtor’s property and is responsible for representing the debtor during litigation and arbitration.⁷² Thus, this position is very powerful.

IV. China, Banking, Bankruptcy and WTO Reforms

A. Background on China’s Membership in the WTO

The 2006 Bankruptcy Law came at a time of major change in the way that China regulated its domestic market as well as its external relations with the other trading nations of the world.⁷³ For the past twenty years China has been negotiating bilaterally and multilaterally for entry into the WTO, formerly known as the General Agreement on Tariffs and Trade (GATT).⁷⁴ In order to become a full member of the WTO, China had to negotiate not only multilaterally with the existing members of the organization, but it also had to negotiate bilaterally with its major trading partners over more specific areas of concern.⁷⁵ In 2001 China was finally granted full membership in the WTO.⁷⁶ China’s entry into the WTO presents many opportunities for growth and development, and is a significant milestone for the world economy. However, the conditions of China’s participation in the world trading body also brings with it many short-term uncertainties.⁷⁷

69. *Id.*

70. *Id.*

71. *Id.* art. 25.

72. *Id.*

73. See Peter K. Yu et al., *China and the WTO: Progress, Perils, and Prospects*, 17 COLUM. J. ASIAN L. 1 (2003) (examining China’s entry into the WTO, and identifies the major areas of change that may occur).

74. Karen Halverson, *China’s WTO Accession: Economic, Legal, and Political Implications*, 27 B.C. INT’L & COMP. L. REV. 319, 324-25 (2004).

75. *Id.*

76. *Id.*

77. See Lee, *supra* note 4, at 481-506.

The 2006 Bankruptcy Law is just one of the many legal and economic reforms that China will adopt and implement in conjunction with its participation in the WTO, and many of these reform measures will be adopted in quick succession over the next few years.⁷⁸ China has committed to pursue reforms in banking, trade tariffs, subsidies to SOEs,⁷⁹ agriculture and many other sectors. These reforms will have a far-reaching impact upon almost all segments of the Chinese economy as it continues to transform into a free market economy. It is safe to say that in the next ten years China will undergo unprecedented fundamental change.⁸⁰

B. Banking Reform Under WTO Protocol

China's reform of its state-owned banking sector has been the subject of much attention and apprehension in recent years.⁸¹ It has become even more frenzied as China steps into its role as a full-fledged member of the WTO.⁸² The opening and reform of the domestic banking industry coupled with the application of the new Bankruptcy Law could have an acute impact on unemployment and social stability in China.

Under its accession protocol, China has committed to opening up its formerly highly protected and highly coveted domestic banking industry to competition from foreign financial institutions.⁸³ Foreign banks are eagerly awaiting the opportunity to enter into the domestic banking market in order to compete for the deposits of the Chinese people, some of the world's most impressive savers.⁸⁴ The World Bank estimates that the net savings rate in China hovers around 30 to 40 percent of gross national income, as compared to the 5 percent net national savings rate of the United States.⁸⁵ At least 85 percent of total Chinese household assets are parked in bank accounts in the form of savings.⁸⁶ Under China's WTO commitments, foreign banks will be able to offer services to domestic consumers in the local currency and compete directly for deposits.⁸⁷

78. *Id.* at 488.

79. Julia Ya Qin, *WTO Regulation of Subsidies to State-Owned Enterprises (SOEs)—A Critical Appraisal of the China Accession Protocol*, 7 J. INT'L. ECON. L. 863, 863-68 (2004).

80. Halverson, *supra* note 74, at 323-24.

81. Chen, *supra* note 2.

82. *Id.*

83. *Id.*

84. *Id.* at 241.

85. World Bank Environmental and Economic Indicators (2000), <http://siteresources.worldbank.org/INTEEI/214578-1110886258964/20748133/Appendix3.pdf>.

86. *See* Chen, *supra* note 2, at 241.

87. *Id.* at 239.

C. Banking Reform and SOEs—the Complex Relationship

The reform of China's banking laws will have a particularly strong impact on corporate bankruptcies because state banks are carrying so many bad loans belonging to highly indebted companies, particularly SOEs. Many of these companies may choose to seek bankruptcy protection under the new laws.⁸⁸ This situation is further complicated by the fact that Chinese workers, throughout the past two decades of exceptionally high economic growth, have loyally and consistently deposited a huge proportion of their earnings in government owned banks.⁸⁹ Thus, Chinese state banks have been able to freely extend credit to floundering SOEs for years because of the overabundance of savings deposited by the Chinese worker into savings accounts across the country.⁹⁰

Banks are further pressured by the government, keen on keeping people employed and maintaining a high growth rate, to extend loans to loss-making SOEs and other problematic business enterprises. Private banks that are less vulnerable to that sort of government pressure would probably exercise more discretion regarding to whom they choose to loan money.⁹¹ The extension of loans from state-owned banks to SOEs also functions as a not-so-subtle subsidy for the failing SOEs.

Additionally, the lack of transparency, rife corruption and patronage networks have allowed Chinese companies to obtain loans for which they would otherwise probably not have qualified.⁹² China became acutely aware of this problem in the wake of the 1997/1998 Asian Financial Crisis when private and state owned banks across Southeast Asia, in countries that arguably had, on paper, more developed and transparent banking practices, collapsed under the weight of billions of dollars in bad loans.⁹³

In 2000, China established a system of state-financed Asset Management Companies (AMCs) that wrote off and transferred some of the bad loans from state banks into the hands of the AMCs.⁹⁴ The AMCs, which are coincidentally funded by the same state banking industry, function as quasi-bankruptcy clearinghouses that dispose of the assets of non-performing loans ("NPLs").⁹⁵ This allows banks

88. Halverson, *supra* note 74, at 334.

89. See Chen, *supra* note 2, at 240-52.

90. *Id.*

91. *Id.*

92. *Id.* at 244.

93. See Schreiber, *supra* note 42.

94. Chen, *supra* note 2, at 251.

95. *Id.*

to wipe non-performing loans from their books — immediately, miraculously bringing balance sheets back to health.⁹⁶ However, although the non-performing loan is no longer on the books—it does still exist because no money has been transferred.⁹⁷ The fundamental problem also still exists, because the banking sector is still too closely related to failing SOEs.⁹⁸

The state-owned banking sector in China is, therefore, not as healthy as the government portrays it to be.⁹⁹ It was recently reported that a manageable 7.5 percent of loans in China's commercial banking sector could be considered to be non-performing.¹⁰⁰ However, the real, off the books, figure could be many times higher because bad loans are frequently transferred into the hands of the AMC's in a convenient account maneuver—thus wiping the loan from the books even though it still exists in reality. Additionally, many of the bad loans in the Chinese banking system were unsecured loans made to finance speculative projects in real estate and other investments that have very little hope of ever being recovered.¹⁰¹ The major Chinese state banks are still relatively unaware of the true magnitude of decades of freely loaning money to un-profitable SOEs because they have a monopoly grip over a huge domestic banking market, and thus, funds are continually replenished by Chinese citizens depositing money.¹⁰²

D. With More Choices Where Will the Chinese Deposit Their Money?

The state-owned commercial banks in China, and by extension the failing SOEs that rely on them, will face its true test when the domestic banking sector opens to foreign competition pursuant to WTO protocol this year (2008).¹⁰³ The fear is that ordinary Chinese families and business people will shift their savings out of the state owned banks and transfer them into foreign banks, which they may view as more stable than their domestic competitors.¹⁰⁴ With so much of their personal wealth and long term security bundled up in bank accounts, many Chinese may

96. *Id.* at 255.

97. *See id.* at 240-52.

98. *Id.*

99. David Barboza, *A Rare Look at China's Burdened Banks*, N.Y. TIMES, Nov. 15, 2006, at B1.

100. *Id.*

101. *Id.*

102. *Lee, supra* note 4.

103. *Id.*

104. *Id.*

jump at the opportunity to transfer some, or all, of their nest eggs to more secure institutions.¹⁰⁵

However, it is more likely that state banks will begin to lose customers slowly to foreign banks who may court depositors more aggressively and may offer more innovative products and services.¹⁰⁶ If this trickle becomes a flood, Chinese state banks might not be able to adapt quickly enough to compete.¹⁰⁷ However, Chinese banks, do have the considerable advantage of dominating the domestic market and having a huge infrastructure and depositor base already in place.

E. State Owned Banks Will Tighten Their Lending to SOEs, Inevitably Leading to More Bankruptcies

Though a run on the bank and a total collapse of the domestic banking industry is an unlikely “worse case scenario,”¹⁰⁸ chances are good that the state-owned commercial banks will be forced to tighten and reevaluate their lending relationships with the riskier SOEs.¹⁰⁹ The Chinese banks should, by transferring their worst non-performing loans into the hands of the AMCs, and through government support, be able to adapt to the more competitive environment. In this business environment highly in debt SOEs will probably face real difficulties in accessing capital. Additionally, WTO regulations, if followed, also greatly constrain the Chinese government’s latitude in handing out subsidies to SOEs.¹¹⁰ Thus, simply waiting for a bail out or a tax break is not a viable option for SOEs.¹¹¹ Without access to easy credit, and without generous protection and subsidies from the government, many SOEs might be forced into bankruptcy.

The new 2006 Bankruptcy Law, if its provisions are put into full effect, will increase the number of bankruptcy filings.¹¹² Increased bankruptcies, under the new 2006 Law, might be potentially very painful for the Chinese government, as it is already straining to maintain high growth and employment rates.¹¹³ Unemployment and underemployment are already significant problems in China, with migrant workers barely escaping rural poverty and accounting for twenty-five

105. Chen, *supra* note 2, at 241.

106. Lee, *supra* note 4, at 491-492.

107. *Id.*

108. Interview with Anna Han, Professor, Santa Clara University School of Law, in Santa Clara, Cal. (Oct. 2006).

109. See Chen, *supra* note 2, at 240-261.

110. Qin, *supra* note 75.

111. *Id.*

112. See Sprayregen et al., *supra* note 14, at 60.

113. See Qin, *supra* note 79.

to thirty percent of the population in some urban areas.¹¹⁴ Unemployment in China is currently estimated to hover between four and ten percent for the working age population.¹¹⁵ These figures will certainly increase in response to the 2006 law, as more and more people continue to abandon farms and rural areas to search for jobs in cities.¹¹⁶

V. Conclusion

The successful implementation of the new Chinese Bankruptcy Law in 2007 will likely have an overall positive effect in helping China to correct many of the imbalances produced during the course of its evolution into a market economy. The implementation, however, will not come without its costs; and the short term rise in unemployment and adjustments resulting from more bankruptcies could be severe. During that time, the Chinese government will be under even greater pressure to improve education system and worker re-training programs. This period may also call for the development of social welfare safety nets to assist workers who are transitioning to new jobs, as well as those workers who might have to permanently exit the work force.

The 2006 Bankruptcy Law, along with the other legal reforms to be phased in as China fulfills its WTO commitments, will help to build the foundations for more transparent and sustainable economic development. The Chinese government, state owned banks, and SOEs must work together to ensure that the new bankruptcy system does not become an ineffective “paper tiger.” The threat of corruption and unfair implementation of the rules could also undermine the bankruptcy system and stall economic growth. The 2006 Bankruptcy Law will become indispensable as the Chinese economy becomes more advanced and complex.

114. Yu et al., *supra* note 73, at 15-16.

115. *Id.*

116. *Id.*

